

Negotiable Instruments Question

Employee was Lawyer's bookkeeper. Employee's responsibilities included paying Lawyer's bills, receiving payments from Lawyer's clients, posting those payments to the proper client accounts, and depositing checks and cash into Lawyer's business account at Bank. Employee did not have authority to sign or indorse checks on behalf of Lawyer. If a check required a signature or an indorsement, Employee secured Lawyer's signature.

Employee recently disappeared. Shortly thereafter, Lawyer discovered that Employee had been stealing from Lawyer for several weeks. Although the amounts taken or misapplied by Employee were usually quite small, in two cases the amounts were rather substantial.

In one case, Employee entered into an agreement to purchase a car from Dealer, falsely telling Dealer that the car was for Lawyer's business. Employee and Dealer agreed that Employee would pay the \$10,000 price by check and that the car would be delivered once the check had cleared.

Employee prepared a check for \$10,000 drawn on Lawyer's business account and payable to the order of "Dealer." She included the check among a group of checks that she gave Lawyer to sign. Lawyer, who was pressed for time, signed all the checks without carefully examining them, including the check to Dealer.

Employee delivered the check to Dealer. However, by the time Dealer presented the check for payment, Lawyer had discovered Employee's fraud and instructed Bank to dishonor the check. Bank followed the instruction and dishonored the check, which was then returned to Dealer. The car is still in Dealer's possession.

In the second case, Employee forged Lawyer's signature on the back of a \$5,000 check from a third party payable to the order of Lawyer. Employee then cashed the check at Checkco, a check-cashing service. Checkco subsequently obtained payment of the check from the bank on which it was drawn.

Dealer has demanded payment of the \$10,000 check from Lawyer.

Lawyer has demanded that Checkco pay him \$5,000.

1. Is Lawyer liable to Dealer on the \$10,000 check? Explain.
2. Is Checkco liable to Lawyer for \$5,000? Explain.

Negotiable Instruments Analysis

(Negotiable Instruments IV.A., B., D.; V.B.)

- Legal Problems:
- (1)(a) Is Dealer entitled to enforce the \$10,000 check against Lawyer?
 - (1)(b) Does Lawyer have a defense to payment of the check to Dealer?
 - (1)(c) Is Lawyer's defense of ordinary fraud available against Dealer, the holder of an instrument who received it in exchange for a promise that has not yet been performed?
 - (2) When a check with a forged indorsement is transferred to a check-cashing service, is the original payee of the check entitled to recover from the check-cashing service when the forgery was committed by an employee to whom the payee had given responsibility for handling the check?

DISCUSSION

Summary

Dealer is a holder of the \$10,000 check that was dishonored and can enforce the check against Lawyer. However, Lawyer signed the check only because of Employee's fraud, and Lawyer therefore has a defense to payment that can be asserted against anyone who is not a holder in due course. Dealer is not a holder in due course because Dealer did not give value for the check—Dealer never delivered the car to Employee. Thus, although Dealer can enforce the check, Dealer will be subject to Lawyer's defense of fraud in the inducement.

Checkco is not liable to Lawyer for taking the \$5,000 check with the forged indorsement because Employee was entrusted by Lawyer with responsibility for the check and, therefore, for these purposes, Employee's forgery is effective as the indorsement of Lawyer.

[NOTE: Because the facts of this question include the collection of checks by banks, UCC Article 4 (Bank Deposits and Collections), which is not included in the Negotiable Instruments specifications for the MEE, is implicated. However, the issues raised by this question are Article 3 (Negotiable Instruments) issues, and reference to UCC Article 4 is not necessary to resolve them.]

Point One(a) (20%)

Dealer is entitled to enforce the check against Lawyer because Dealer is a holder of the check.

The \$10,000 check is payable to the order of Dealer and is in Dealer's possession. Dealer is accordingly a holder of the check, UCC § 1-201(b)(21), and is "a person entitled to enforce" it. UCC § 3-301. Lawyer signed the check as drawer and the check has been dishonored. Therefore Lawyer is obliged to pay the check to a person entitled to enforce it. UCC § 3-414. Consequently, Dealer has a *prima facie* claim to payment from Lawyer.

Point One(b) (25%)

Lawyer has a personal defense of fraud in the inducement.

Lawyer has a defense to payment. Lawyer signed and issued the check because of Employee's fraudulent act of including the check among a group of checks intended to pay Lawyer's ordinary business expenses. Under UCC § 3-305, this fraud is a defense to Lawyer's obligation to pay the check. *See* UCC 3-305(a)(2) & cmt. 2 ("the obligation of a party to pay an instrument" is subject to any defense that would be available to the party in an action to enforce "payment under a simple contract," including defenses of fraud, misrepresentation, and mistake). Dealer, as a person entitled to enforce Lawyer's check, will be subject to this defense unless Dealer is a holder in due course. *See* UCC §§ 3-305(a), 3-305(b) (in general, the right to enforce an instrument is subject to both real and personal defenses, but a holder in due course is subject only to the so-called "real defenses," which do not include ordinary fraud).

[NOTE: Some applicants may erroneously argue that this defense is good even against a holder in due course because there was fraud in the factum—Lawyer did not know what he was signing. But UCC § 3-305(a)(1) allows a fraud defense to be asserted against a holder in due course only if the fraud induced the obligor to sign the instrument without a "reasonable opportunity" to learn its terms. Here Lawyer knew he was signing a check and had an opportunity to learn its terms—he could have read it.]

Point One(c) (25%)

Dealer is not a holder in due course because he did not give value for the check.

A holder in due course is a holder who took the instrument for value, in good faith, and without notice of, *inter alia*, any defenses to it. UCC § 3-302(a). Although Dealer does not appear to have acted in bad faith or to have had notice of Lawyer's defense, Dealer has not given "value" for the instrument within the meaning given to that term in Article 3 of the UCC.

Here Dealer took the negotiable instrument (the check) as payment for the car. However, Dealer has not delivered the car. When a negotiable instrument "is issued or transferred for a promise of performance," the promisor gives value only "to the extent the promise has been performed." UCC § 3-303(a)(1). Thus, because Dealer did not perform its promise—delivering the car—it did not take the check for value.

Because Dealer did not take the check for value, Dealer is not a holder in due course. Dealer, as a mere holder, is therefore subject to Lawyer's defense. Lawyer does not have to pay \$10,000 to Dealer.

Point Two (30%)

Even though Checkco took the stolen check, it is not liable to Lawyer because Lawyer had entrusted responsibility for the check to Employee, and Employee's fraudulent indorsement of the check in Lawyer's name therefore is treated as an effective indorsement.

The check that was transferred to Checkco was originally made payable to the order of Lawyer. While the check appeared to carry Lawyer's indorsement, the indorsement had been forged by Employee. Normally, the forged indorsement would be ineffective, Employee would not be a holder of the check or a person entitled to enforce it, and Checkco's action of taking the check by transfer from Employee would be a conversion of that check for which Checkco would

be liable to Lawyer. UCC § 3-420(a). *See also* UCC §§ 1-201(b)(21) (definition of holder), 3-301 (definition of person entitled to enforce).

In this case, however, the result is different. According to the facts, Employee had the authority to process checks and to deposit those checks in Lawyer's business account. This constitutes "responsibility" for those checks. *See* UCC § 3-405(a)(3). Because the fraudulent indorsement of Lawyer's signature on the instrument was perpetrated by Employee, a person to whom Lawyer entrusted "responsibility with respect to the instrument," the indorsement is effective as Lawyer's indorsement. UCC § 3-405. Inasmuch as the indorsement was effective, Employee was a holder of the check and, thus, a person entitled to enforce it. As a result, Checkco did not obtain transfer of the check from a person not entitled to enforce it and, accordingly, Checkco's action did not constitute conversion and Checkco is not liable to Lawyer for the amount of the check.

[NOTE: Lawyer would have a claim to recover some part of the loss from Checkco if Checkco "fail[ed] to exercise ordinary care" in taking the instrument from Employee and that failure contributed to the loss. *See* UCC § 3-405(b). There are no facts in the problem to suggest a lack of care by Checkco, but some applicants may note the possibility that Lawyer could recover some portion of the value of the check from Checkco if Lawyer proved that Checkco failed to exercise ordinary care.]

[NOTE: References to UCC § 1-201 are to the current official text. In states in which former Article 1 is still in effect, citations will be slightly different. There is no difference in substance.]